NFHA
National Fair Housing Alliance

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August 15, 2007

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. OP-1288; Home Equity Lending Market Request for Comment

Dear Ms. Johnson:

On behalf of the board and members of the National Fair Housing Alliance, I am writing in response to the Federal Reserve Board's request for comment on the home equity lending market. It is evident that this country is in a state of emergency with regard to the home lending market. Just last week, the Fed poured $62 billion into the market to create liquidity, due in large part to the serious failures in the subprime market. It is time for the Fed to use its authority under the Home Ownership and Equity Protection Act (HOEPA) to prevent further unfair and deceptive practices in this market that have caused billions of dollars in losses. As described below, these losses have had a disproportionate impact on people and communities of color.

Now is the time for some real protections for families and individuals. Although many of these loans may not have been illegal and may have contained some form of disclosure, communities suffered catastrophic losses because the Fed has acted to slowly to implement sufficient protections. Borrowers received, and continue to receive, loans that they never could have paid back. Astonishingly, many of the loan originators who peddled these loans knew very well that the borrowers did not have the ability to pay them back; however, these loans are pushed because lenders reap large profits from them. And while pushing these loans may not be ethical, in many cases, it is legal. While unscrupulous lenders made these loans, it is unfortunately, the entire economy that is reaping the consequences.

Founded in 1988, the National Fair Housing Alliance is a consortium of more than 120 private, non-profit fair housing organizations, state and local civil rights groups, and individuals from 37 states and the District of Columbia. Headquartered in Washington, D.C., NFHA, through comprehensive education, advocacy and enforcement programs, provides equal access to apartments, houses, mortgage loans and insurance policies for millions of people. Immediately following the hurricanes on the Gulf Coast, NFHA created the Hurricane Relief Project, which works with its Gulf Coast member fair housing agencies to assist homeowners in hurricane-affected areas in the FEMA declared disaster counties. The project seeks to assist individuals resolve their mortgage delinquency and obtain equitable settlements on their homeowners insurance claims. The project also seeks to ensure fair access to insurance and mortgage lending; to reduce mortgage loan default and foreclosure; to prevent construction fraud; and to facilitate the re-building of inclusive communities and ensure equal housing opportunity for all. In addition, many of NFHA's members work in their communities to fight predatory lending through education and enforcement, as well as assist individuals and families resolve their individual loan problems through loan modifications and counseling.

A. Prepayment penalties

Should prepayment penalties be restricted? For example, should prepayment penalties that extend beyond the first adjustment period on an ARM be prohibited? Would enhanced disclosure of prepayment penalties help address concerns about abuses? How would a prohibition or restriction on prepayment penalties affect consumers and the type and terms of credit offered?

The Fed Should Prohibit the Use of Prepayment Penalties on Subprime Loans

Prepayment penalties have been a disservice to subprime borrowers and should be prohibited. These penalties have not only trapped borrowers into higher priced and unsuitable loan products but have not resulted in a trade-off benefit to borrowers in the form of a commensurate reduction in rate. A recent study by the Center for Responsible Lending, as well as other studies and anecdotal evidence, show that borrowers do not get an interest rate benefit with prepayment penalties.[1] Their terms are often complex and burdensome. Why would a borrower agree to be trapped in a high rate loan and pay a hefty fee if a better deal comes along? Moreover, why would a borrower agree to such an onerous loan provision with no or very little benefit in return? The simple fact is that many borrowers do not understand the terms of

[1] Ernst, Keith. *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages,* Center for Responsible Lending, January 2005.

prepayment provisions; and many do not know that they have them. Too many lenders take unfair advantage of consumers who are not educated about what the prepayment penalty is and who do not understand how obtaining one should affect their interest rate.

Prohibition of prepayment penalties is especially important in the subprime market where it has been abused the most. Only 2% of prime loans carry the penalty,[2] and it is clear that absence of the penalty has not hindered the prime market. We believe that, likewise, an absence of the penalty will not inhibit the subprime market.

There is an important fair housing concern with the practice of apportioning prepayment penalties. Borrowers who live in predominately African-American neighborhoods are disproportionately placed in loans with prepayment penalties. For a family with a $150,000 mortgage at an interest rate of 10 percent, a typical prepayment penalty imposes a fee of $6,000 for an early payoff—an amount *greater than the entire net worth of the median African-American family*.[3] It is clear that, left to police itself, the industry has done a very poor job. It is high time for the Fed to step in and appropriately monitor the industry and restrict abusive practices.

Disclosures are not the answer. Although every loan should have sufficient and effective disclosures, families and individuals need real protections from unfair and deceptive practices. The Fed must use its authority to define these practices.

B. Escrow for taxes and insurance on subprime loans

Should escrows for taxes and insurance be required for subprime mortgage loans? If escrows were to be required, should consumers be permitted to ``opt out'' of escrows? Should lenders be required to disclose the absence of escrows to consumers and if so, at what point during a transaction? Should lenders be required to disclose an estimate of the consumer's tax and insurance obligations? How would escrow requirements affect consumers and the type and terms of credit offered?

The Fed Should Require Escrowing for Taxes and Insurance on Subprime Loans

Unlike typical prime loans, subprime loans generally do not escrow for taxes and insurance. Indeed, many prime loan originators automatically include escrow payments for taxes and insurance and the consumer must, if the note allows it, opt out of escrowing. Subprime lenders generally do not escrow and this often results in

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[2] Bocian, Debbie and Richard Zhai, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans*, Center for Responsible Lending, January, 2005. Page 1.

[3] *Ibid.*

borrowers' receiving payment shock, the surprise of higher mortgage costs than expected. Failure to escrow also is associated with expensive and unfair force-placed insurance and higher delinquency and foreclosure rates.

The Fed should require that taxes and insurance be escrowed for subprime loans. The escrowing should also be calculated as part of a borrower's ability to repay the loan. This is standard practice in the prime market and may well be a significant reason why prime loans are better performing than subprime loans. The loan's disclosures should also have a description in clear language of what taxes and insurance escrowing means, how much it is, how the taxes and insurance will be paid, and what the borrower should do in the event that he or she learns that the payments are not being made.

Escrow disclosures should be made to the consumer at the beginning of and throughout the application process. This point is critical because many loan originators use a deceptive sales tactic of comparing the borrowers current mortgage containing escrows to a new, supposedly lower mortgage payment, that does not include escrows. If lenders were required to disclose this information upfront to consumers, this practice would be significantly abated. Moreover, throughout the application and underwriting process, as the terms and conditions of the loan may change, new complete and full disclosures should be made to the borrower.

C. ``Stated income" or ``low doc" loans

Should stated income or low doc loans be prohibited for certain loans, such as loans to subprime borrowers? Should stated income or low doc loans be prohibited for higher-risk loans, for example, for loans with high loan-to-value ratios? How would a restriction on stated income or low doc loans affect consumers and the type and terms of credit offered? Should lenders be required to disclose to the consumer that a stated income loan is being offered and allow the consumer the option to document income?

The Fed Should Prohibit Stated Income and Low-Doc/No Doc Loans

Stated income and low-doc/no doc loans are not viable and are not needed in the market. In our experience and the experience of our fair housing centers nationwide, these loans have served to increase the payment to the broker and the lender but have not provided a benefit to the borrower. Moreover, high instances of fraud are associated with stated income, low-doc and no-doc loans.

All of the people NFHA and its member organizations have served who have received these loans did not realize that they were getting this type of loan. Indeed, the borrowers either provided or would have provided the necessary documentation for a

full-doc loan but this information either was not used by the loan originator or the loan originator neglected to request the information from the borrower. Often full income documentation is included in the file, but disregarded resulting in the borrower paying a higher premium.

Brokers have also used these loans to falsify a borrower's ability to repay by highly inflating the borrower's income. NFHA and its members have assisted consumers whose incomes were clearly inflated. In fact, NFHA is currently assisting a borrower whose mortgage broker attributed a job and income to her that she did not have. She only learned of the deception well after the loan was closed. It is quite evident that the mortgage broker committed fraud (indeed he has fled the state), however, both her first-mortgage servicer and second-mortgage servicer have been unwilling, despite all of our efforts, to work with her to avoid foreclosure. This borrower has had to seek assistance from benevolent and governmental organizations in order to make her loan payments. But this limited help is running out. From NFHA's experience, it is much easier and cheaper to prohibit the opportunity for such practices to occur on the front end as opposed to sustaining an environment that allows them to flourish and then trying, after the fact, to cure the damage.

Many prime lenders already use alternative forms of documentation to allow for underwriting for a wide array of consumers. Creditors should be required to use the best and most appropriate form of documentation available.

D. Unaffordable loans

Should lenders be required to underwrite all loans based on the fully-indexed rate and fully amortizing payments? Should there be a rebuttable presumption that a loan is unaffordable if the borrower's debt-to-income ratio exceeds 50 percent (at loan origination)? Are there specific consumer disclosures that would help address concerns about unaffordable loans? How would such provisions affect consumers and the type and terms of credit offered?

The Fed Should Require that All Loans Be Underwritten to the Maximum Possible Payment

Lenders should be required to underwrite all loans based on the maximum possible payment under the loan. This can usually be reached during the first three-to-four years based on our calculations.

The fully-indexed rate is an insufficient measure of a borrower's ability to repay. The National Fair Housing Alliance has analyzed the impact of applying the fully-indexed rate standard, rather than the stronger maximum possible payment standard, on

adjustable rate loans of many homeowners who are seeking relief from ever increasing mortgage payments. Almost every loan NFHA has reviewed is either a 2/28 or 3/27. The interest rate on 2/28 and 3/27 loans reset after the initial 2 or 3 year period and then every six months thereafter. **In almost every case, the initial rate was higher than the fully-indexed rate applicable to that loan.** According to the loan terms, the interest rate on these 2/28 or 3/27 loans can never go below the introductory rate. Therefore, underwriting these loans to the fully-indexed rate is meaningless, since the fully-indexed rate is a rate that would never be applied.

The Fed should require that creditors originate loans where the borrower has the ability to repay the loan under the terms of the contract. For too long, loan originations have been based on the assessed risk to the creditor and the investor. The borrower's risk must be front and center in this analysis.

The Fed should require stricter underwriting if a borrower's income-to-debt ratio exceeds 50%. For example, if a borrower has substantial documentation to show that he/she can afford a housing payment that is 55% of the household income and that the borrower has amply paid this amount over a sufficient period of time, this may be considered an acceptable and affordable loan for this consumer. Additionally, allowing a loan where the borrower's income-to-debt ratio exceeds 50% will be dependent on the borrower's assets and total debt. All of these things should be taken into consideration when determining whether or not a loan is affordable.

ADDITIONAL CONCERNS

E. The Fed Should Eliminate Yield Spread Premiums in the Subprime Market

Our primary concern regarding this issue lies in the wide range of abuses consumers have sustained with the YSP. Because the industry's standard is that the YSP is not included in the HOEPA calculation, many mortgage brokers have used the back-end commission to hike their income while simultaneously inflating the borrowers' payments, charging borrowers exorbitant fees for services.

The YSP is frequently utilized in conjunction with the prepayment penalty so that any benefit in cost reduction that the borrower might have reaped due to the addition of the penalty is offset by the increase in interest rate brought on by the YSP. In fact, this practice disproportionately impacts African-American and Latino borrowers.[4]

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[4] See footnotes 2 and 3.

YSPs strongly encourage discretionary pricing on subprime loans and prepayment penalties lock borrowers into these loans. Brokers receive considerable compensation for steering borrowers into higher rate loans with YSPs and prepayment penalties.

The lending industry has allowed these abusive and discriminatory practices to flourish unchecked. In many cases, the borrower would have been better served, if there were not enough funds for commission and closing costs, to have those costs rolled into the mortgage, financing them on the front-end, as opposed to having the commission (or in many cases a portion of the commission) paid on the back-end with an increase in the interest rate.

A number of fair housing agencies operate foreclosure prevention programs in various regions of the country. Indeed, the National Fair Housing Alliance operates a specialized foreclosure prevention and homeownership preservation program in the Gulf Coast region. These agencies have assisted thousands of consumers in their attempts to save their homes. The fair housing community has never heard of a case in which a mortgage broker provided full disclosure to a borrower about the true nature of the YSP, an explanation of the increased interest rate because of the YSP, or a calculation of the differences in cost to the borrower with or without the YSP.

Typically, borrowers are victims of bait-and-switch tactics at the closing table, since the YSP was never discussed during the loan application process. The interest rate that the borrower was initially quoted is increased and, if the borrower is made aware of the increase, he/she is made aware of the increase at the last minute, often at the closing table. If there is an explanation of the increase in the interest rate, the borrower is told that this was the best deal the broker could find – not that an alternative offer was made by the lender that did not include the YSP. The YSP is never explained to the borrower and the borrower is never made aware of the YSP or its implications.

The industry has not acted responsibly in its employment of the YSP. What's more, the YSP does not really provide a benefit to the borrower. It has been used more often than not to reap more profits for lenders and loan originators. It cannot be argued that the YSP, in this market environment, benefits the borrower.

F. The Fed Must Strengthen Fair Lending Examinations

The Fed needs to enhance its fair lending investigations by broadening them to ensure that all of the institutions affiliated with a lender are abiding by the Fair Housing Act, the Community Reinvestment Act, and other laws, regulations, and guidance. It is not sufficient to simply conduct an examination of the member institution without

simultaneously conducting a thorough exam of the institution's other affiliates, especially its subprime entities and third party originators.

For too long, the Fed and other regulators have relied upon their member institutions to police and monitor their affiliates and third party vendors. Yet, it is these same lenders who state that they have not put in place sufficient screens, requirements and restrictions because they are afraid of losing market share and fear that third party originators will shuffle business to lenders who don't have sufficient restrictions. This is reason enough for the Fed to increase its monitoring of lenders to ensure that fair housing violations are curtailed and that other consumer protections are not vitiated. The prevalence of disparities in the lending market speaks for itself.

Predatory lending has been able to flourish in Latino and African-American communities because federally regulated lending institutions have failed to meet their fair lending and CRA obligations. America has a dual financial system in which high-quality, low-cost credit is abundantly available in predominately White communities and poor-quality, high-cost credit is abundantly available in predominately Latino and Black neighborhoods. While the lending industry seems to be of the opinion that this dual system is just fine, the truth is that access to inferior, sub-standard credit is not access – it is abuse. This system exists because there is a void in under-served communities that high-cost credit providers have seen it profitable to fill. The testimonies of subprime lenders themselves confirm this. Time and again, the subprime industry has argued that they should be lauded because they stepped up to make credit available in under-served areas when the prime market would not.

Blacks and Latinos are more likely than their White counterparts to receive higher-cost loans, according to the *Federal Reserve Bulletin*.[5] Among federally regulated lending institutions, denial rates for African-Americans and Latinos are disproportionately higher than the denial rates for their White counterparts. Among these same institutions, the application and approval rates for African-Americans and Latinos are inordinately low. There is a dearth of mainstream lenders in predominately African-American and Latino communities while there is a proliferation of payday lenders, check cashers and subprime mortgage brokers.

Multiple studies have found that subprime lending is more prevalent among African-American and Latino borrowers. Moreover, the disparities between White and African-American and White and Latino borrowers increase as the income of the borrowers

[5] Avery, Robert, Kenneth Brevoort, Glenn Canner. "Higher-Priced Home Lending and the 2005 HMDA Data," *Federal Reserve Bulletin*, September 8, 2006.

increase.[6] In one study, researchers looked at the multiple distribution points of a major lender and found that most of the loans originated to African-American and Latino borrowers were originated through its high-cost, subprime subsidiary. Unsurprisingly, most of the loans the institution originated to White borrowers were done through its lower-cost prime entity.[7]

While many lenders claim their profile in under-served markets is low because the credit quality in these markets is lower, testing involving loan providers has revealed disparate treatment and biases in the marketplace that have nothing to do with sound underwriting practices.

In the mid 1990s, the National Fair Housing Alliance conducted an eight-city, 600 test lending investigation using testers who posed as first-time homebuyers. While African-American and Latino testers were slightly superior to their White counterparts on all pertinent characteristics including income, credit status, length of employment, loan-to-value ratio, and asset levels, the testing results yielded substantial differences in treatment that favored Whites in two-thirds of the tests. NFHA found that lenders:

1) steered Whites to superior loan products while African-Americans and Latinos were steered to FHA loans, even when their loan amounts exceeded the FHA loan limit;

2) told African-American and Latinos that the qualification standards were more stringent than those quoted to White borrowers;

3) offered higher closing costs to minority testers;

4) gave Whites significant assistance in qualifying for loans while not giving the same to their minority counterparts;

5) provided more information in writing to Whites.

The Urban Institute conducted a lending study using tester pairs in which African-American and Latino testers received superior profiles compared to their White matches. The tests were conducted in Chicago and Los Angeles. As a result of the

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[6] Bradford, Calvin, *Risk or Race? Racial Disparities and the Subprime Refinance Market*, Center for Community Change, May, 2002.

[7] Campen, Nafici, Rust, Smith, Stein, and van Kerkhove, *Paying More for the American Dream: A Multi-State Analysis of Higher Cost home Purchase Lending*, California Reinvestment Committee, Woodstock Institute, et. al., March, 2007.

testing analysis, the Urban Institute concluded that "African-American and Latino homebuyers face a significant risk of unequal treatment when they visit mortgage lending institutions to make pre-application inquiries."[8]

The Fed must also do more to monitor the use of credit scoring systems – many of which have a disparate impact on African-Americans and Latinos. It is no secret that African-Americans and Latinos, on average, have lower credit scores than do Whites. This fact is sufficient to warrant a probe into the efficacy and fairness of the systems. However, the Fed has done little to curtail the usage of these systems or to encourage lenders to use less discriminatory alternatives.

Rating companies such as Moody and Fitch are beginning to re-evaluate the way they assess loan portfolios and borrower characteristics given the mass under-performance of the market. These companies are coming to the conclusion that credit scores do not hold as much predictive value as they had once thought. In fact, they are recognizing what civil rights and consumer organizations have known for years: that loan terms and conditions and servicing quality may have more to do with loan performance than credit score. Indeed many Community Development Financial Institutions regularly originate loans to consumers with very low credit scores with a great deal of success. As Dr. Calvin Bradford notes, many lenders seem to be oblivious to the fact that the overwhelming majority of loans made to borrowers with credit scores under 620 (up until the current mortgage crisis at least) did not default and performed fine.[9]

It is critical to keep in mind that the lender has superior knowledge over the consumer. Consumers do not come to the table with a full understanding of the ins and outs of YSPs, prepayment penalties, HOEPA triggers, escrow accounts, or even the difference between prime and subprime. What's more, the APR has become a useless tool in today's environment. For years, consumers have been told that they can use the APR to effectively shop for the best loan. However, particularly in the subprime market, the APR received by the consumer at closing is hardly ever the APR that was initially quoted to them. This makes shopping for a loan next to impossible. The cards are stacked against consumers from the beginning and this must change.

Because the lender has the inevitable advantage of knowledge, the industry has an obligation to serve consumers honorably and ethically. This obligation is too often

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[8] Turner, Freiberg, Godfrey, Herbig, Levy and Smith, *All Other Things Being Equal: A Paired Testing Study of Mortgage Lending Institutions*, Urban Institute, April, 2002.

[9] Roche, Smith, Bradford, McCorkell, *Perspectives on Credit Scoring and Fair Mortgage Lending; Credit Scoring Overview*, Federal Reserve Bank of San Francisco. Available at http://www.frbsf.org/publications/community/investments/0303/article1.html

ignored. The burden now shifts to the Fed to institute the measures that will bring consumer protections and help ensure fair lending compliance.

G. Preserving Homeownership

The Federal Register specifically requested comment regarding action the Fed should take regarding HOEPA. However, we would like to take this opportunity to strongly encourage the Fed to consider its obligations to subprime consumers beyond the scope specifically outlined in HOEPA. We want to encourage the Fed to do all it can to preserve homeownership and even to work behind the scenes to push lenders and the capital markets to vigorously work toward finding solutions to avoid foreclosure.

For example, the Fed can weigh in on issues regarding the strict interpretation of Financial Accounting Standards Board (FASB) rules that may prohibit the ability of loan servicers to modify loans. Likewise, the Fed can add to the discussion about whether or not investors who allow work-outs and loan modifications are violating their authority and right to do so. Some hedge funds are beginning to argue that investors are going beyond their scope in allowing work-outs and may be susceptible to lawsuits.

There are, undoubtedly, many other issues that have or will come up related to this foreclosure crisis. Many of these issues may never come to public light. We urge the Fed to take a position, whenever it can, on these issues that supports homeownership preservation and expands protections for consumers.

Thank you for the opportunity to comment. The Fed has shown in recent months that it is well aware of the serious damage that unscrupulous lenders and brokers have done to the market. The Fed, in fact, had to step in to provide some relief to the stock market just last week, something it has not had to do since September 11th.

We hope to see an increased dedication by the Fed to assist borrowers by defining unfair and deceptive practices, as well as the other recommendations above, in order to improve the economy as a whole.

Sincerely,

Shanna L. Smith
President and CEO